10-Step Guide to Preparing a Development Credit Authority (DCA) Project

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Purpose of 10-Step Guide

The *10-Step Guide* describes the steps required to prepare a Development Credit Authority (DCA) guarantee. It is addressed to USAID Mission staff who are interested in designing their first proposal and who require an overview of the start-to-end process.

The *10-Step Guide* is meant as a companion to the *DCA Operations Manual*, which provides a more detailed description of the role and responsibilities of each party, as well as examples of the various documents to be prepared. These two documents, as well as other resources, can be accessed at www.usaid.gov/economic_growth/dc/.

DCA Overview

The Development Credit Authority allows USAID Missions to fund projects that are financially viable through loan and bond guarantees in sectors that meet sustainable development objectives. Typical recipients of the guarantee facility are creditworthy borrowers such as local governments, private sector entities, and non-governmental organizations (NGOs). USAID can also provide Portfolio Guarantees to financial institutions that extend loans to a broader number of small borrowers such as microenterprises and small businesses.

By sharing the credit risk with financial institutions, DCA is able to demonstrate the soundness of lending activity in sectors that may not otherwise have access to capital. With sufficient experience and credit history, local banks can then have greater confidence in issuing additional loans in targeted sectors without further USAID participation.

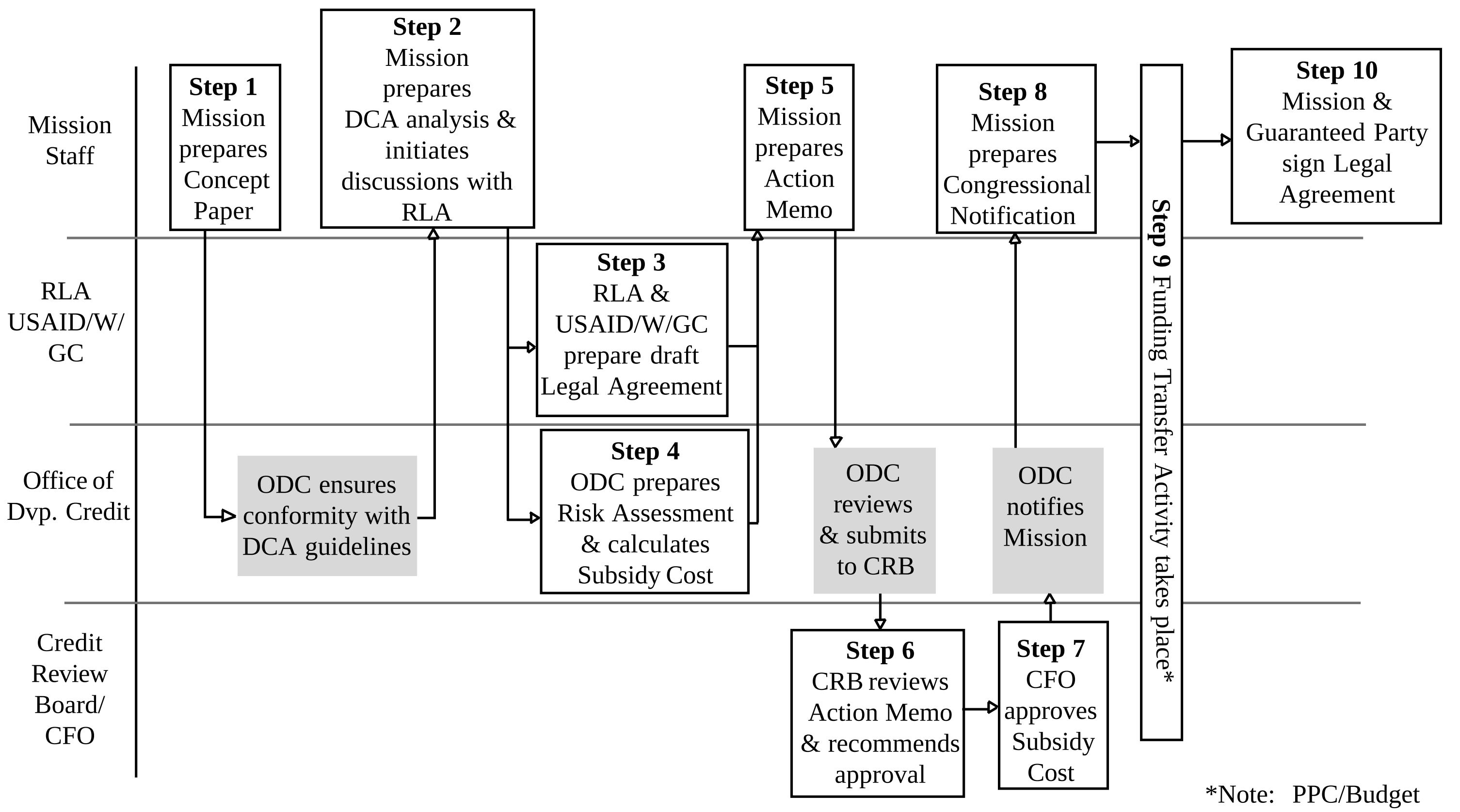
To ensure that projects fit within the DCA guidelines, proposals should preferably follow these general principles:

- **Financial Viability:** Projects should demonstrate positive financial rates of return, indicating that debt can be repaid.
- **Risk Sharing:** USAID should assume 50 percent or less of the potential liability to ensure true risk sharing with local financial institutions.
- **Leverage**: USAID credit activity should directly mobilize funding by local financial institutions.
- **Currency Matching**: Loans guaranteed by DCA should be made in the same currency as the revenues generated by the project.
- **Reporting Requirements:** USAID Missions should be prepared to work with the partner financial institutions to provide regular reports on the status of DCA projects.

10-Step Process for Project Approval

Several groups within USAID play a key role in negotiating, preparing, approving, and releasing funds for DCA projects: Mission Staff, Regional Legal Advisors (RLA), the Office of Development Credit (ODC), the Office of the General Counsel (USAID/W/GC), the Credit Review Board (CRB), the Chief Financial Officer (CFO), and the Bureau of Program Policy Coordination (PPC/Budget).

The timeframe for getting a DCA project approved varies depending on the project, however, a Mission should estimate that it will take three to nine months from project development to final approval. The following chart identifies the principal steps involved in getting a DCA proposal approved:



DCA Roles and Responsibilities

Step 1: Mission prepares Concept Paper

When first considering a DCA project, the Mission should prepare a short ***Concept Paper*** that gives an overview of the proposed activity. This Concept Paper is a useful tool for the Mission to articulate its objectives and to outline the intended structure of the guarantee.

The Concept Paper describes the following:

- Purpose and scope of the project
- Proposed structure of the agreement
- Funding sources
- Name of Guaranteed Party
- Type of Credit Facility (loan, portfolio, portable, or bond guarantee)
- Estimated Amount of Project Financing (maximum portfolio size)
- Guarantee Ceiling (maximum USAID contingent liability)
- Guarantee Percentage
- Term of Guarantee (number of years)
- Project monitoring plan
- Timeframe for implementation

There are a number of different ways to identify opportunities for DCA guarantees. Some Missions host informational seminars with the local financial, business, and political communities to explain the purpose and guidelines of the Development Credit Authority. Others rely on existing contacts with prospective lenders and borrowers to explore possibilities for USAID involvement.

When preparing the Concept Paper, the Mission is encouraged to work closely with the ODC. With its institutional knowledge of past DCA projects, ODC staff can help screen opportunities based on the lessons learned from previous DCA projects. Using this experience, the ODC may suggest improvements or other changes to the Concept Paper. ODC staff can also provide technical guidance in defining the scope of a proposal and outlining initial terms and conditions. Missions should also consult the regional and/or technical bureaus for advice and counsel.

Upon completion, the Mission sends the Concept Paper to the ODC, where it is reviewed for conformity with DCA guidelines and for overall soundness.

Concurrently, the Mission also indicates to the ODC the amount of Mission resources (from the Operating Year Budget) that it is willing to commit to the project. At this point, the ODC is not in a position to provide a final Subsidy Cost (see Step 4); however, it can evaluate the general terms of a proposed facility on the basis of previously approved DCA guarantees in order to give the Mission a preliminary estimate of risk and potential Subsidy Cost. In addition, the ODC may express concerns about the overall riskiness of a DCA proposal and suggest ways for the Mission to improve the financial soundness of the project structure. These suggestions can help the Mission minimize the anticipated Subsidy Cost by reducing the overall transaction risk.

Step 2: Mission prepares DCA analysis & initiates discussions with RLA

After the Concept Paper has been reviewed by the ODC, the Mission focuses on preparing the background analysis that will accompany the Action Memorandum. This analysis is an essential part of the proposal as it presents the development, economic, and financial justifications for the proposed activity.

While the Mission prepares the analysis, the Office of Development Credit is available to respond to requests for assistance by field offices. ODC staff can support Missions with project reviews, overall process issues, and background analysis, as well as provide guidance in structuring agreements. The ODC can also recommend experts for short-term support if technical assistance is required.

During this phase, the Mission is responsible for collecting the financial background information and project specifics that will allow the ODC to perform its Risk Assessment (see Step 4).

The Mission should also hold preliminary discussions with the Regional Legal Advisor (RLA). This is an opportunity to brief him/her on the project specifics and to start defining the proposed terms and conditions of the Legal Agreement (with advice and counsel from USAID/W/GC and ODC). This step is very important, as the RLA will provide guidance on how to structure and prepare the Legal Agreement with the financial institution and/or Guaranteed Party.

Section	*Purpose*	*Responsibility*
Development Analysis	Ensures that the DCA proposal meets USAID strategic objectives	Mission
Economic Viability Analysis	Verifies that USAID is the guarantor of last resort and is addressing market imperfections	Mission
Financial Viability Analysis	Determines whether the project can recoup operating and debt servicing costs	Mission
Financial Monitoring Plan	Shows how the Mission plans to monitor the DCA facility	Mission
Fees Justification	Demonstrates that fees charged to the Guaranteed Party are appropriate.	Mission
Risk Assessment	Evaluates the financial viability of a DCA proposal and calculates the Subsidy Cost	ODC

Contents of an Action Memorandum

Six major sections will typically be attached to an Action Memorandum:

1. **Development Analysis:**
   - Describes the role of the DCA proposal in meeting key developmental goals of the host country.
   - Explains how the proposed activity fits within the Mission's current or planned Strategic Objectives.

2. **Economic Viability Analysis:**
   - Determines that the DCA proposal addresses in-country market imperfections, does not supersede private sources of financing, and ensures that USAID is acting as the guarantor of last resort.
   - Identifies the necessary investment activities that are currently not taking place due to distortions in the capital market.

3. **Financial Viability Analysis:**
   - Calculates Cash Flow, Internal Rate of Return and Net Present Value to determine that the proposed activity will yield a positive rate of return after meeting operational and debt servicing costs.

4. **Financial Monitoring Plan:**
   - Demonstrates that the Mission has the capacity and necessary resources to monitor a DCA activity.
   - Designates Mission staff responsible for collecting reports, communicating with the ODC, and managing the schedule of activities and deadlines.

5. **Fees Justification:**
   - Ensures that fees charged to the Guaranteed Party are within the range stipulated by DCA guidelines.
   - Explains how fees charged to the Guaranteed Party will encourage utilization of the guarantee.

6. **Risk Assessment**: The Mission collects background information to allow the Office of Development Credit to complete a detailed risk assessment (see Step 4). This information includes:
   - Three to five years of audited financial statements.
   - Financial projections showing growth plans and anticipated profitability.
   - Business or strategic planning documents.
   - Organizational charts, along with CVs of key personnel.
   - Internal policies and control systems of financial institutions, such as operations manuals, credit management systems, term deposit programs, training plans, and human resources policies.

Step 3: RLA drafts Legal Agreement

The Mission works with the Regional Legal Advisor (RLA), USAID/W/GC and ODC to develop the financial terms of the proposed DCA activity. The Guarantee Term Sheet (see diagram to the right) is then incorporated into the ***Legal Agreement,*** which is signed at the end of this process by the Mission and the Guaranteed Party (see Step 10). The RLA uses an existing template from USAID/W/GC and the Guarantee Term Sheet to prepare the Legal Agreement, which sets forth the key terms and conditions of the guarantee.

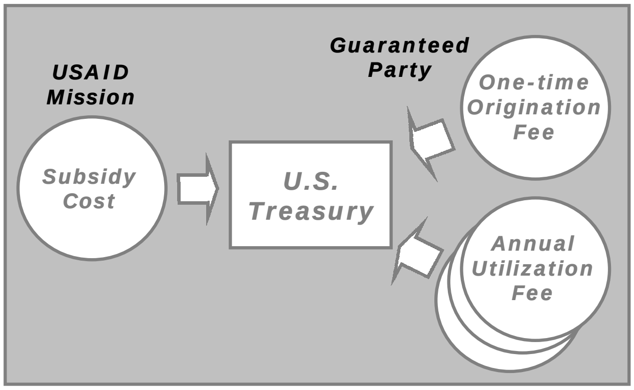
Guarantee Term Sheet

- Name of Guaranteed Party
- Type of DCA Credit Tool
- Maximum Loan/Portfolio Amount (US$)
- USAID Guarantee Percentage
- Maximum USAID Contingent Liability (US$)
- Term (years)
- Expiration Date
- Loan Currency (local or US$)
- Origination and Utilization Fees
- For Portfolio Guarantee Only:
  - -Qualified Borrowers
  - -Maximum Individual Loan Amounts
  - -Qualified Projects
- Other specific facts of the deal

Step 4: ODC prepares Risk Assessment and calculates Subsidy Cost

On the basis of information collected by the Mission and other sources of risk-related information, the ODC prepares a ***Risk Assessment***, which evaluates the financial viability of a DCA proposal. The Risk Assessment analysis determines the probability of default on a loan or loan portfolio: the higher the level of risk, the greater the probability of loss.

The Risk Assessment is then used to calculate the ***Subsidy Cost***. This represents the amount of money that USAID will set aside from its budget to be put into the USAID account at the U.S. Treasury Department. This account (which is also funded by the fees paid by the Guaranteed Party, see diagram) can be viewed as a "loan loss reserve" account. It is used to pay any claims that are made by the Guaranteed Party for defaulted loans under the DCA agreement.



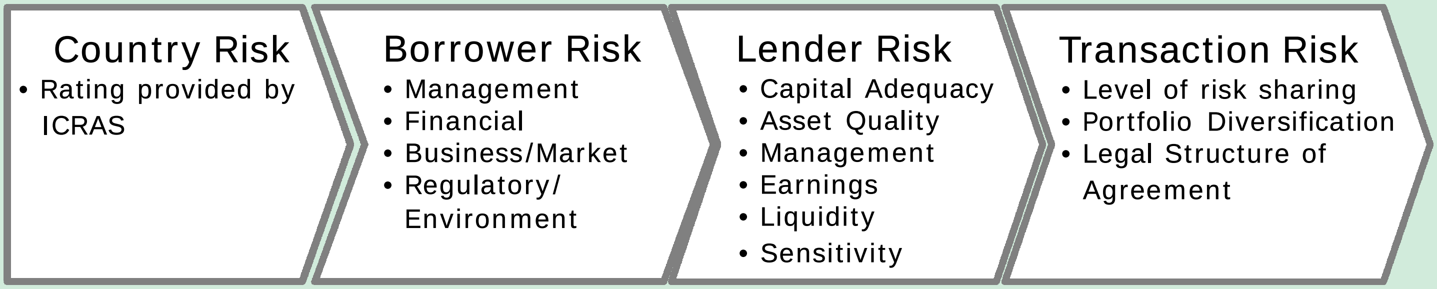
Transfers to the U.S. Treasury

The diagram to the right demonstrates the two sources of funding for the "loan loss reserve" account. The Mission pays the risk-based Subsidy Cost. The Guaranteed Party typically pays an ***Origination Fee*** on the guaranteed portion of the maximum loan amount and an annual ***Utilization Fee*** on the outstanding guaranteed amount.

The amount paid by the Mission and the Guaranteed Party has a direct correlation: the lower the Origination and Utilization Fees charged to the Guaranteed Party, the higher the subsidy cost to the Mission (and vice versa). The Mission sets the fee levels during negotiations with the Guaranteed Party of the terms of the Legal Agreement.

It is the ODC's responsibility to perform the Risk Assessment and calculate the Subsidy Cost using a risk model, which is based on four key components (see chart on the next page):

- The ***Country Risk,*** which typically accounts for 40 percent of the risk assessment, is determined by a rating system used throughout the U.S. Government. This system, the Inter-Agency Country Risk Assessment System (ICRAS), takes into account such factors as foreign exchange conditions, banking and legal systems and the overall business climate.
- The ***Borrower Risk*** analyzes the creditworthiness of the entity responsible for loan repayment. It includes a review of the borrower's business plan, financial statements, and internal policies. It also assesses the quality and experience of the management team.
- The ***Lender Risk*** analyzes the creditworthiness of the financial institution providing the loan(s). USAID uses a widely accepted "CAMELS" analysis to evaluate the bank's **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market factors. If available, the ODC also uses international credit ratings of these institutions.
- The ***Transaction Risk*** looks at the legal and financial structure of the proposed agreement, including the level of risk sharing and the degree of diversification. In this respect, Portfolio Guarantees tend to have lower transaction risks than Loan Guarantees because the risk of default is spread over a larger number of borrowers.



Risk Assessment Conducted by ODC Staff

For Loan Portfolio Guarantees, two key metrics of the lender risk assessment--asset quality and management experience--are given greater weight, since the borrowers are not yet known and the risk is therefore difficult to assess. The bank's ability to measure the risk profile of its customers and to manage and monitor its loan portfolio (including delinquencies) is among the primary determinants of the project's chances for success.

Step 5: Mission prepares Action Memorandum

DCA proposals are structured around the ***Action Memorandum***, which is prepared with five attachments providing the development, economic, financial, and risk analyses underpinning the proposed DCA facility (see Step 2). The Action Memorandum is addressed to the Chief Financial Officer (CFO) and describes the action requested, along with a description of the proposed project activity and the subsidy requirements. The Mission forwards the completed Action Memorandum and its attachments to the ODC.

The Office of Development Credit reviews the Action Memorandum for substance and completeness. If necessary, the ODC provides feedback to the Mission and helps it finalize the contents of the Action Memorandum. This document is then forwarded to the Credit Review Board (CRB).

Step 6: CRB reviews Action Memorandum and recommends approval

The Credit Review Board reviews the Subsidy Cost calculation. It also reviews the financial and economic viability analyses and the financial monitoring plan developed by the Mission. On the basis of this information, the CRB makes a recommendation to the CFO or requests further clarification from the Mission.

Step 7: CFO approves Subsidy Cost

Upon the favorable recommendation of the CRB, the CFO approves the Subsidy Cost calculation and verifies that the allocated transfer is within the existing budgetary ceiling. The CFO is mandated to approve (or reject) the Subsidy Cost calculation within 15 days of receiving the CRB's recommendation.

The ODC is notified immediately by the CFO of the guarantee's approval (or rejection). The ODC, in turn, informs the Mission of the outcome and guides it through the next steps.

Step 8: Mission prepares Congressional Notification

If approved, the Mission prepares a Congressional Notification (CN) and submits it to its Regional Bureau, which then reviews and sends the document to the USAID Bureau of Legislative and Public Affairs for submittal to the U.S.Congress. Once the 15-day CN waiting period has expired without Congressional objection, the Mission Controller or Program Officer requests that the Regional Bureau Controller or Program Officer transfers the appropriate amount of funds from the Development Assistance (DA) account to the DCA account.

Step 9: Funds are transferred

The Development Credit Authority is a financial transfer authority, not a direct line item appropriation. The cost of credit assistance is met by transferring funds appropriated for bilateral assistance to a DCA account after the Congressional Notification period has expired.

Generally, the transfer of funds to the DCA account follows these steps:

- The Bureau of Policy, Program, and Coordination (PPC) makes an appropriate reduction of the funds allowed to the Mission, thus regaining control of the necessary funds.
- PPC, in conjunction with the Regional Bureau, sends a request to the U.S. Office of Management and Budget (OMB) and the U.S. Treasury to reduce the budget authority level in the relevant appropriation account, and to increase, by the commensurate amount, the budget authority level of the DCA account.
- OMB makes the apportionment of the DCA account budget authority to USAID.
- PPC makes an allowance of the DCA budget authority to the Regional Bureau.
- The Regional Bureau sends an email regarding the allowance of the funds to the Mission. The email provides a funding citation to enable the Mission Controller to enter the funding in the Mission accounting system.

At this point, the transfer has been executed and the funds are back under the control of the Mission. The Mission Controller can now certify the availability of sufficient DCA budget authority to permit legal obligation.

Step 10: Mission and Guaranteed Party sign Legal Agreement

The Mission Director and the Guaranteed Party sign the ***Legal Agreement***. The Mission obligates funds immediately after signature and notifies the ODC that the subsidy is obligated.

The implementation and monitoring phase begins once the Legal Agreement is signed. Financial and performance monitoring activities are essential for ensuring that utilization of the guarantee is consistent with the Legal Agreement's terms and conditions, that outstanding guarantee fees are paid in a timely manner, and that the financial institution is managing the guaranteed loan(s) in a prudent way.

Examples of DCA Guarantees

By mobilizing private capital, DCA demonstrates to the local banking community the economic viability of specific types of investments. Here are some examples of DCA projects that were successfully implemented. Missions may also refer to ***Best Practices of USAID's Development Credit Authority***.

Loan Guarantees

- Unión Progreso, a rural credit union in Northern Mexico, is using a three-year loan from a U.S. bank to increase its capital base, increase micro-lending activity beyond its core agricultural business, and expand its network of agencies.

Portable Guarantees

- The Greater Johannesburg Municipal Council in South Africa secured a ten-year loan from a local bank for much needed infrastructure investments to improve the delivery of water, electricity, and solid waste services.
- USAID/Morocco is providing a portable loan guarantee to Al-Amana, one of the leading microfinance institutions in Morocco, to promote home improvement micro-loans.

Loan Portfolio Guarantees

- Bancafé, a leading Guatemalan bank, is expanding its microloans in rural areas poorly served by banks. To extend its reach, it is wholesaling part of its lending activity through a microfinance Private Voluntary Organization.
- The DCA facility is helping the United Bulgarian Bank demonstrate the financial viability of municipal and private sector investments in energy efficiency projects. Most investments have payback schedules of less than three years.

Bond Guarantees

- To stimulate the municipal bond market in the Philippines, the DCA facility is encouraging local banks to invest in the Local Government Unit Guarantee Corporation, an institution designed to promote long term lending to local governments.
- In India, a fifteen-year bond guarantee is supporting the establishment of the "Water and Sanitation Pooled Fund," which will onlend to several municipal water and sanitation projects.

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